As Published in yc magazine

How to get Audited by the IRS

The North Carolina Society of Accountants just published an article based on a report from the National Society of Accountants.

The Society reports that IRS is stepping up audits of business returns reported on Schedule C, which is the tax form used by sole proprietors and single-member LLC's. The Schedule C is by far the most common business tax return used by small business.

The IRS estimates the "tax gap"—the difference between what taxpayers voluntarily pay and what they really owe—is now $345 billion—that's Billion—dollars.

And they believe that much of that tax gap comes from the ubiquitous Schedule C.

So guess what? Look for more Schedule C returns to be audited.

Personally, that's fine with me. I'm an honest and loyal taxpayer. While I'm willing to pay my share, I'm really not willing to underwrite someone else's share, particularly if that someone is using fraudulent means to avoid paying their tax.

RED FLAGS FOR AUDIT
So here are some red flags to avoid if you are a Schedule C small business tax filer.

Using the Wrong Accounting Method. Cash, accrual, or hybrid accounting methods are used by various businesses. But companies that have inventory should usually use the hybrid method.

Lack of documentation of Auto Expenses. I see this one every day. It's a juicy deduction, and should be—vehicles are expensive to operate. But IRS expects you to maintain records to prove your deduction, which is fair enough. Most people don't; they just say, "Oh, use 29,000 miles!" That's almost a $13,000 deduction, and I think it reasonable for IRS to say, "OK, can you prove that?"

Keep the mileage log, and you'll be fine. Claim a $13,000 deduction without documentation, and you're asking the Revenue Officer to dig deeper to see what else can be found. It's a major RED FLAG.

Improper Meal and Entertainment Expense. Same as the mileage documentation. They realize that we from time to time must wine and dine in the expectation of generating business income. But they also expect the claim for deduction to be legitimate, and to be provable.

Claiming several thousand dollars of meals and entertainment without documentation is—you guessed it—a major RED FLAG.

Unqualified Home Office Deductions. These rules were relaxed a few years back, and made more workable.

The main test now is that the Home Office must be used for the regular and exclusive use of the business. A second bedroom dedicated to the business works. Part of the family room or den doesn't. And shouldn't.

In our practice, we generally see between 8% and 12% of the house being deducted for a Home Office. Claim 60%, and you'd better be able to back it up! And you'll still get an argument!

THE REDDEST OF ALL FLAGS
Improper Classification of Employees. It's the biggest red flag of all, and the most dangerous to you personally. It's often called Independent Contractor vs Employee. As the owner of the business, you'd prefer to treat people who work for you as Independent Contractors.

It's cheaper for you, and requires much less paperwork. But the reality is that most of these people are technically employees.

And the reality is that if audited, the IRS will make the call, and they will win. It won't even be close.

If that audit goes against you, a whole cascade of bad things happen. You'll become liable for all the back taxes for all the (now) employees for years, the State Department of Revenue, Unemployment Security, and Workers Compensation will get into the act, and the Penalties and Interest meters will begin to run.

They will then audit the employees, hoping to find some that have not voluntarily reported all the income you paid them.

Many businesses and many families that depend on these businesses have been ruined in this way.

WHY IS THIS FLAG LAST?
Here is a plausible audit strategy.

One of the first red flags catches the auditor's—or more likely, the computer's—eye. They then start digging. If they don't find anything besides mileage or a home office deduction, you suffer a financial penalty but no harm otherwise.

But if they see suspicious things in several places—and to a trained eye these things jump out, they then start testing for Independent Contractor vs Employee.

And you have just become the Revenue Officer's pot of gold.

The moral: Claim every dollar you should, keep good documentation, and don't be greedy. It's not worth it.

1171 Market Street, Suite 206, Fort Mill, SC 29708
Phone 803 802 7676
www.beaconsmallbiz.com